

Covered taxes; excise tax based on investment income. The tax imposed under section 4940(a) is an excise tax and not an income tax. Unless an income tax treaty provides otherwise, excise taxes in general or the section 4940(a) excise tax in particular will not be treated as a covered tax under that United States income tax treaty.

#### ISSUE

Whether the tax imposed under section 4940(a) of the Internal Revenue Code is a covered tax for purposes of any United States Income Tax Treaty?

#### FACTS

Section 4940(a) of the Code imposes a tax equal to 2 percent of the net investment income for the taxable year of each private foundation which is exempt from taxation under section 501(a). An exemption from the 2 percent tax on net investment income is available to an exempt operating foundation, effective for taxable years beginning after December 31, 1984, under section 302 of the Tax Reform Act of 1984. In addition, a reduction of the tax on net investment income from 2 percent to 1 percent is available to a private foundation that meets certain distribution requirements, effective for taxable years beginning after December 31, 1984, under section 303 of the Tax Reform Act of 1984.

#### LAW AND ANALYSIS

Generally, in income tax treaties between the United States and other countries, it is stated that covered taxes are limited to federal income taxes imposed by the Code. Thus, unless a tax treaty provides that a tax other than an income tax is a covered tax for purposes of the tax treaty, such tax will not be treated as a covered tax under that income tax treaty.

The legislative history of section 4940(a) of the Code evidences the congressional intent that the tax imposed by section 4940 is an excise tax on investment activity. Section 4940 originated in the House of Representatives as a proposal that would impose a 7 1/2 percent tax on the net investment income of private foundations. Such income was exempt from income taxation under the Code.

The dual purpose of the House proposed tax was (1) to ensure that private foundations would bear part of the cost of government, and (2) to function as a user fee which would help pay the cost of administering the private foundation provisions.

The Senate agreed with the purposes stated by the House for imposing a tax on private foundations. However, the Senate desired to continue the existing income tax exemption for private

foundations and wanted to avoid implying the withdrawal of any portion of the exemption. The Senate, thus, proposed an annual excise tax to be imposed by the new section 4940 of the Code. This excise tax would be an audit-fee tax based upon the value of the noncharitable assets of private foundations. S.Rep. No. 91-552, 91st Cong., 1st Sess. 27 (1969), 1969-3 C.B. 423, 441-442. The Conference Committee reached a compromise, agreeing to the imposition of an excise tax (section 4940 of the Code) based upon a percentage of a class of income (net investment income), although at a lower rate more commensurate with its function as an audit-fee tax rather than an income tax. Thus, Congress intended the tax under section 4940 to be an excise tax on investment activity.

An excise tax is a tax imposed on an activity, the engaging in an occupation, or the enjoyment of a privilege. *Waxenberg v. Commissioner*, 62 T.C. 594, 604 (1974). Section 4940(a) of the Code meets the definition of an excise tax since the tax is imposed only on a foundation's investment activity. See *Lettie Pate Whitehead Foundation, Inc. v. United States*, 606 F.2d 534, 537 (5th Cir.1979). See also section 53.4940-1(a) of the Foundation Excise Tax Regulations which refers to the tax under section 4940 as an excise tax.

#### HOLDING

The tax imposed under section 4940(a) is an excise tax and not an income tax. Unless an income tax treaty provides otherwise, excise taxes in general or the section 4940(a) excise tax in particular will not be treated as a covered tax under that United States income tax treaty.